No. 830

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HAROLD B. WILLEY,

IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

PHILIP F. BOYNTON, PETITIONER,

against

REA FORHAN PEDRICK, as Administratrix of the Estate of William J. Pedrick, deceased, late Collector of Internal Revenue for the Second New York District,

RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION

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IN THE

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No. ....

PHILIP F. BOYNTON,
Petitioner,

against

REA FORHAN PEDRICK, as Administratrix of the Estate of William J. Pedrick, deceased, late Collector of Internal Revenue for the Second New York District,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States.

Your petitioner, Philip F. Boynton, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit. The numbered and lettered headings of this petition are designed to conform to the paragraphs of Rule 23 of this Court.

I (a)
OPINIONS BELOW

The memorandum opinion filed in the District Court appears at page 196 of the record and is not officially reported. The opinion of the Court of Ap-

peals is reported at 228 F. (2d) 745 and appears at page 203 of the record.

I (b)

JURISDICTION

(i) The judgment of the Court of Appeals for the Second Circuit dated December 7, 1955, was entered the same day (R. 207).

(ii) Petition for rehearing was entertained and denied by order dated January 11, 1956 (R. 218).

(iii) The jurisdiction of this Court is invoked under 28 U. S. Code 1254 (1).

I (c)

QUESTIONS PRESENTED FOR REVIEW

The following Constitutional questions were presented to the lower courts and fully argued as the *foundation* of the petitioner's cause of action; but the lower courts not only have not discussed them in their opinions (R. 196-201; 204-206), they are hardly mentioned.

The questions are these:

1. Does not the Sixteenth Amendment (appx. p. 15), by limiting the power granted to tax "derived" income, guarantee to this taxpayer the right to have his taxable income computed by the cash receipts and disbursements method?

2. Does not Article I, § 9, of the Constitution (appx. p. 15) protect this taxpayer against direct taxation of other than "derived" income "unless in proportion to the census or enumeration" provided for in the Constitution?

3. Did not the action of the Commissioner in holding that the use of inventories is necessary in order to

determine the petitioner's income subject the petitioner to illegal discrimination in that the Commissioner had previously determined that the use of inventories is not necessary to calculate the income of farmers who report on the cash basis (Reg. 111, Sec. 29.22[a]-7 [appx. p. 17])?

4. Since an accrual set of books also includes complete accounts on the cash receipts and disbursements basis does not a taxpayer have the right to report his income on the cash basis in any event under I.R.C. 1939, § 41 (appx. p. 16)?

5. Has not the petitioner been deprived of the right of trial by jury recognized in § 3772(d) of the Internal Revenue Code (1939) and the Seventh Amendment to the Constitution?

I (d)

The following Constitutional provisions, statutes and regulations are involved in this case. Their pertinent text is set forth in the appendix hereto.

Article 1, Section 9, of the Constitution
The Sixteenth Amendment of the Constitution
38 Stat. 114, Section II, B (Revenue Act, 1913)
39 Stat. 756, Chap. 463, § 8(g) (Revenue Act, 1916)
Internal Revenue Code, 1939, Section 22(c)
Internal Revenue Code, 1939, Section 41
Internal Revenue Code, 1939, Section 293(a)
Treasury Decision No. 2433 (January 8, 1917)
Internal Revenue Bureau, Reg. 111, § 29.22 (a)-7
Internal Revenue Bureau, Reg. 111, § 29.23 (a)-11

Internal Revenue Bureau, Reg. 111, § 29.22 (c)-1
Internal Revenue Bureau, Reg. 111, § 29.41-3 (1)

For the convenience of the Court, the portions of the above emphasized by the petitioner are italicized.

I (e)

STATEMENT OF THE CASE

The following facts are not in dispute.

The petitioner (taxpayer) kept an honest and accurate set of books of his business (R. 28, 29, 33) which recorded every business transaction (R. 81).

His books clearly reflected his taxable income on the cash basis and he accordingly filed his income tax return on the cash basis (§ 41 I.R.C., 1939, appx. p. 16).

In 1939, the petitioner commenced business as a leather jobber. His practice was to purchase pickled sheep-skins and process them into finished leather which he held for sale (R. 69-70). He paid for the skins and for processing labor and materials out of gross cash receipts and the cost thereof—paid in cash—he deducted from gross cash receipts in calculating income for tax purposes at the end of each taxable year. The cash method has long been a recognized method of accounting (R. 91; Report No. 992 [July 5, 1916] Ways and Means Committee on Bill H. R. 16763, 64th Cong. 1st Sess. p. 3; Int. Rev. Bulletin, Cumulative Bulletin 1939-1 [Part 2] p. 24).

All cash received and disbursed was entered in the petitioner's books (Exhibits 1, 2 and 3 [R. 71-2]) which also included a record of all sales, purchases and manufacturing costs.

At the end of each calendar year he took a physical inventory for the purpose of preparing reports for

bank credit and insurance purposes. Such inventory was not recorded in his books and was not a part of his accounts.

As he was unfamiliar with accounting procedures, his books were posted and audited by a public accountant who also prepared his federal income tax returns. He instructed his accountant that his tax returns be prepared on the cash basis (R. 73) in which no inventory is used.

Until November, 1946, petitioner's income tax returns on the cash basis had been accepted by the Internal Revenue Bureau without question, but on November 22, 1946, the Bureau sent the petitioner two notices of alleged deficiencies (Exhibits 7 and 8 [R. 158-173]) for the calendar years 1943 and 1944, respectively.

In these notices the Commissioner ruled that the petitioner was obliged to report his income on an accrual basis because he had year-end inventories (notwithstanding the inventories were not integrated in his books of account) on the alleged ground that the use of inventories was necessary in order clearly to determine the income of the taxpayer pursuant to Reg. 111; § 29.22(c)-1, the validity of which the petitioner attacks.

The petitioner contested the Commissioner's ruling as illegal and in violation of his constitutional rights:

(a) because the Sixteenth Amendment permits only the taxation of "derived" (received) income without apportionment among the States, and thus contemplates the cash method as the sole method of computing taxable income thereunder;

(b) because he was thereby grossly discriminated against by the Commissioner who had already determined by Regulation that the use of inventories is not

necessary when net income is computed by farmers on the cash basis (Reg. 111; § 29.22[a]-7 [appx. p. 17]);

(c) because the Commissioner denied the petitioner the equal protection of the laws in that the petitioner was deprived of the right to compute his net income in accordance with his method of accounting pursuant to said § 41 I.R.C. (1939) as farmers are permitted to do;

(d) because the use of an accrual method of computing taxable income is optional with the taxpayer, subject only to the approval of the Secretary of the Treasury (39 Stat. 756; ch. 463, § 8[g] [appx. p. 15]);

(e) because the petitioner's income tax as computed by the Commissioner by an accrual method violates Art. I, § 9 of the Constitution in that it was not apportioned among the States in proportion to the census.

It is undisputed that inventories are an integral part of any accrual method of accounting (R. 91, 107, 109, 200); and that the use of inventories is not necessary as an element of the cash method (R. 91-2).

The wide disparity between the petitioner's tax as computed by the cash method and the accrual method used by the Commissioner (calculated upon the same books and records) is clearly shown by a comparison of results for the years 1943 and 1944 in the following table, conceded to be accurate (R. 176):

	1943	*1944*
Commissioner's computation ...	$9,983.93	$20,923.18
Cash method	4,284.67	3,586.95
Difference	$5,699.26	$17,336.23

The petitioner paid the alleged deficiencies—with interest and assessed penalties (I.R.C. § 293[a])—under protest (R. 174, 175). He filed claims for re-

fund and exhausted all his administrative remedies before bringing this suit (R. 10, 15-16, 61-62).

The petitioner brought suit on the civil side in the U. S. District Court for the Southern District of New York under § 3772(d) of the Internal Revenue Code of 1939, against the estate of the then deceased Collector of Internal Revenue who had collected the alleged deficiencies and penalties. The United States Attorney appeared and defended on behalf of the defendant estate (28 U.S.C. § 507[3]). The suit was brought to recover the sum of $27,054.60 with interest thereon from the 16th day of December, 1948, when collection was made.

The defendant moved for summary judgment dismissing the complaint with respect to all issues except that relating to opening inventory and penalties. The motion was denied by Judge RYAN with a memorandum opinion (R. 53) holding that there was a question of fact involved as to whether the plaintiff's method of keeping his accounts more clearly resembles cash than accrual.

The suit came on for trial before Hon. EDWARD P. MURPHY, *J.* and a jury. The plaintiff's offer of Treasury Decision No. 2433 (appx. p. 17) was excluded (R. 89-90). At the close of the plaintiff's case the defendant moved for a directed verdict of dismissal for so much of the case as is directed to the tax liability of the plaintiff (R. 111, 112). The Judge overruled the ruling of Judge RYAN (R. 115) and granted the motion (R. 118).

The trial then proceeded as to the propriety of the imposition of the penalty and the Judge propounded two questions to the jury (R. 153) to be answered "yes" or "no".

> "Was the plaintiff's failure to report his income for the year 1943 [1944] in the manner

prescribed by law, due either to negligence or to intentional disregard of rules and regulations."

The plaintiff excepted to the questions (R. 154). The jury found "due to negligence" (R. 157).

The Court of Appeals (R. 205, 206) affirmed without discussing the Constitutional questions and made a holding as to negligence which impairs the petitioner's right to his day in Court (R. 154).

I (h)

ARGUMENT FOR ALLOWANCE OF THE WRIT

This petition presents questions of much public importance and broad application as to the interpretation of the Sixteenth Amendment which have not been considered by this Court, but should be.

This Court has not considered the fact that in a full accrual set of books there is always contained a complete account of cash receipts and disbursements which clearly reflects income on the cash basis. We have found no discussion of this important fact in any decision of any court.

Since this petitioner kept an accurate set of books on the cash basis he is entitled to compute and report his income on that basis because the Sixteenth Amendment (appx. p. 15) permits taxation only of "derived" income without apportionment among the States. Income is money (*Maryland Casualty Co.* v. *U. S.* (1917), 52 Ct. Cls. 201, 209-10) and derived means received or drawn (*Eisner* v. *Macomber* (1920), 252 U. S. 189, 206, 207). This interpretation is recognized in the Revenue Act of 1913 (appx. p. 15) and in Treasury Decision No. 2433 (appx. p. 17) issued on January 8, 1917, which uses the cash receipts and disbursements basis as the standard of reflection of true net income.

The purpose of the Sixteenth Amendment was to repeal Art. 1, § 9 of the Constitution (appx. p. 15) to the extent of "derived" income as the result of the decision in *Pollock* v. *Farmers' Loan & Trust Co.* (1895), 157 U. S. 429.

Thus income computed by an accrual method is not covered by the Sixteenth Amendment and must be apportioned pursuant to Art. I, § 9 of the Constitution.

Accrual income is not "derived" income because accrual accounting taxes accounts receivable and inventories which are not liquidated during the taxable year. In addition, an accrual return, as in this case (R. 96) denies the taxpayer a deduction for cash actually expended during the tax year for the purchase of inventory on hand at the end of the year. This conflicts with Reg. 111, § 23(a)-11 (appx. p. 17) which recognizes the right of farmers on the cash basis to deduct *all* cash expended during the year for seeds, fertilizers, insecticides, etc., on hand at the end of the year. This petitioner was denied a deduction of $15,696.61 in cash expended during the year 1944 on year-end inventory (R. 96).

It is essential that the Regulations of the Internal Revenue Bureau, particularly Reg. 111, § 29.22(c)-1 (appx. p. 17) and Reg. 111, § 29.41-3(1) (appx. p. 18) be brought into harmony among themselves and with the Constitution. Reg. 111, § 29.22(c)-1 is carried over in Reg. 118, § 39.22(c)-1 and Reg. 111, § 29.41-3(1) is carried over in Reg. 118, § 39.41-3(a), indicating a continuing policy of the Internal Revenue Bureau.

The present illegal practice of the Commissioner of Internal Revenue in imposing an accrual method of computing income arbitrarily upon merchants and manufacturers with year-end inventories, if condoned by this Court, can be extended to include farmers

whose inventories of crops, seeds, fertilizers, herds, hides and dairy products also fall within the category of "income-producing factors" within the meaning of Reg. 111; §§ 29.22(c)-1 and 29.41-3(1).

There can be no doubt that the production of crops, and the purchase of seeds and insecticides and the sale of crops, hides and dairy products are "income-producing" factors in the business of farming (the trial judge prevented an exploration of the subject [R. 92]).

Two serious evils are inherent in the contradictory treatment of inventories by the Bureau of Internal Revenue under the diametrically opposed Regulations 29.22(c)-1 and 29.22(a)-7 in that (1) merchants and manufacturers are now grossly discriminated against by the confiscation of their right to compute their incomes by the cash method without using inventories while farmers' Constitutional rights under the XVI Amendment are at present respected, and (2) when such unlawful conduct under I.R.C. 22(c) (appx. p. 16) shall have become firmly established, then farmers with their huge inventories will be faced with a *fait accompli* when the Bureau then proceeds to confiscate the farmers' right to report on the cash basis and to tax their inventories. This conflict of decision in the Bureau itself demands to be resolved by this Court equally with conflicts between Circuit Courts.

The decision of the Court of Appeals for the Second Circuit conflicts in particular with the decisions of the Court of Appeals for the Sixth Circuit in the case of *Glenn* v. *Kentucky Color & Chemical Co., Inc.*, 186 F. (2d) 975 and of the Circuit Court of Appeals for the Ninth Circuit, in the case of *Osterloh* v. *Lucas*, 37 F. (2d) 277.

The decision also conflicts in general with the decisions of this Court, holding that taxing laws are to be construed in favor of the taxpayer whenever any doubt arises as to interpretation.

U. S. v. *Merriam* (1923), 263 U. S. 179, 187;
Martin v. *Hunter's Lessee* (1816), 1 Wheat. 304, 325;
Gibbons v. *Ogden* (1824), 9 Wheat. 1, 188-9;
U. S. v. *Wigglesworth* (1842), 2 Story 369, 373-4;
Bowers v. *N. Y. & Albany Lighterage Co.*, 273 U. S. 346, 350;
Gould v. *Gould*, 245 U. S. 151, 153.

In applying § 41 of the Code (1939), the district judge recognized (R. 197) that his decision conflicts with the Ninth Circuit in *Osterloh* v. *Lucas*, 37 F. (2d) 277 and with the Sixth Circuit in *Glenn* v. *Kentucky Color & Chemical Co.*, 186 F. (2d) 975 and cited the decision of the Second Circuit in *Caldwell* v. *Comm'r*, 202 F. (2d) 112 in support of his conclusion.

In the *Glenn* case the Sixth Circuit held that the taxpayer was entitled to report on the cash basis under § 41 when his books reflected his income on the cash basis (with only minor deviations). The Court said (p. 977):

> "The statute requires only that the taxpayer's books shall be kept fairly and honestly, without any attempt to evade the tax."

and cited *Osterloh* v. *Lucas*, 37 F. (2d) 277, where the Circuit Court for the Ninth Circuit said at page 278:

> "In our opinion all that is meant is that the books shall be kept fairly and honestly; and when so kept they reflect the true income of the taxpayer within the meaning of the law."

The district judge stated (R. 197) that the above language had been rejected by the Ninth Circuit in the later case of *Herberger* v. *Comm'r*, 195 F. (2d) 293,

but in the *Herberger* opinion the Court made no mention of the *Osterloh* case and stated (p. 295):

> "The *Beckman, Mann* and *Glenn* cases differ materially from the case at bar and are, we think, not in point here."

In the *Herberger* case the Court pointed out (p. 295) that the taxpayers took inventories and *used* them in making their tax returns.

The *Caldwell* case is not in point because the Court (Second Circuit) stated specifically (p. 113):

> "Taxpayer had always used inventories in *calculating his taxable income* from this enterprise, but reported only the actual cash received during the calendar year from both credit and cash sales." (Italics ours.)

In that case the Court also pointed out (p. 116) that "a change to the accrual method of reporting income *thus required no change* in his bookkeeping method" and (p. 115) that the taxpayer did not challenge Reg. 29.22(c)-1.

The case at bar includes three critical distinguishing facts. (1) It *was* necessary to change the petitioner's bookkeeping method to make it accrual (R. 87, 90), (2) the petitioner *did not* use inventories in making returns and (3) the petitioner *does* challenge Reg. § 29.22(c)-1. The petitioner claims that § 22(c), I.R.C. (1939) and Reg. 111, § 29.22(c)-1 were intended to apply only to accrual returns made voluntarily by the taxpayer in accordance with the option granted in the 1916 Revenue Act (appx. p. 15) and the policy of Treasury Decision No. 2433 (appx. p. 17) promulgated under that Act.

The right of a business man to keep a record of the debts owing to him and a record of the debts he owes without thereby jeopardizing his right under the XVI

Amendment to compute his net income on the cash basis should be confirmed by this Court.

The principal reason for the contradictions and obscurities in the reported decisions seems to be a universal tendency of the courts to confuse "sales accounting" and "paper profits" with "income" as defined by the XVI Amendment and the early decisions of the Courts prior to the Revenue Act of 1918 and Treasury Decision No. 2433 (R. 185).

The direction of the verdict by the trial judge denied the petitioner's right to a trial by jury upon the following questions, among others:

1. Whether the petitioner's method of accounting more clearly resembles cash than accrual (R. 53).

2. Whether the petitioner's method of accounting clearly reflected his taxable income under the XVI Amendment (R. 197).

3. What the petitioner's taxable income was for the years 1943 and 1944, determined on the facts under applicable principles of law.

Helvering v. *Taylor,* 293 U. S. 507, 515;
Miles v. *Safe Deposit & Trust Co.,* 259 U. S. 247, 251;
Welp v. *U. S.* (8 CA), 201 F. (2d) 128, 133.

And, finally, the adverse socialistic effects upon the national economy of the administration of income taxation are now so apparent that this Court should proceed to contain within strict constitutional limits this enormous and expanding power to undermine and weaken the foundations of the Republic.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the United States

Court of Appeals for the Second Circuit, commanding that court to certify and to send to this Court for its review and determination, a full and complete transcript of the record and proceedings of the case entitled on its docket "*Philip F. Boynton,* Plaintiff-Appellant v. *Rea Forhan Pedrick,* as Administratrix of the estate of William J. Pedrick, deceased, late Federal Collector of Internal Revenue in and for the Second New York Division" and that said judgment of said court be reversed.

HORACE M. GRAY,
Counsel for Petitioner.

April 5, 1956.

APPENDIX

Art. I, § 9 of the Constitution reads:

> "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

This is the text of the Sixteenth Amendment:

> "The Congress shall have power to lay and collect taxes on *incomes,* from whatever source *derived,* without apportionment among the several states, and without regard to any census or enumeration."

38 Stat. 114, Section II B, App. Oct. 3, 1913:

> "B. That, subject only to such exemptions and deductions are hereinafter allowed, the net income of a taxable person shall include gains, profits and income *derived* from salaries, wages, or compensation for personal services of whatever kind and in whatever form *paid,* * * *."
>
> * * * * *
>
> "That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses *actually paid* in carrying on any business * * *."

39 Stat. 756; Chap. 463, § 8(g), App. Sept. 8, 1916:

> "An individual keeping accounts upon any basis *other than that of actual receipts and disbursements,* unless such other basis does not clearly reflect his income, *may,* subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make his return upon the basis upon which his accounts are kept, in which case the tax shall be computed upon his income as so returned."

Section 22(c) of the Internal Revenue Code (1939), provides:

> "*Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as *most* clearly reflecting the income."

The 1939 Code provides in § 41 that:

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the *method of accounting regularly employed* in keeping the books *of such taxpayer;* but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

Section 293 (a) of the 1939 Code provides:

> "Sec. 293. *Additions to the Tax in Case of Deficiency.*
>
> (a) *Negligence.* If any part of any deficiency is due to negligence, or intentional disregard of rules and regulations but without intent to defraud, 5 per centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected and paid in the same manner as if it were a deficiency, except that the provisions of section 272(i) relating to the pro-rating of a deficiency, and of section 292, relating to interest on deficiencies, shall not be applicable."

Treasury Decision #2433 provides in pertinent part (the complete text is printed R. 184-7):

> "If upon investigation it shall be found that returns made upon the basis of accruals and reserves do not reflect the true net income, the corporation so failing in this way to return the true net income will not thereafter be permitted to make its returns upon any basis *other than that of actual receipts and disbursements.*"

Reg. 111; § 29.22(a)-7 provides:

> "*Gross Income of Farmers.*—A farmer reporting on the basis of receipts and disbursements (in which *no inventory to determine profits is usd*) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received during the taxable year from the sale of live stock and produce which were raised during the taxable year *or prior years,* (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other sources." (Italics ours.)

Reg. 111; § 29.23(a)-11 provides:

> "*Expenses of Farmers.*—A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses *all amounts actually expended* in the carrying on of the business of farming * * *."

Reg. 111; § 29.22(c)-1 provides:

> "*Need of Inventories.*—In order to reflect the net income correctly inventories at the beginning and end of each taxable year are necessary *in every case* in which the production, purchase or sale of merchandise, is an income-producing factor."

Reg. 111; § 29.41-3(1) provides:

> "(1) In all cases in which the production, purchase, or sale of merchandise *of any kind* is an income producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) *should* be taken at the beginning and end of the year and used in computing the net income of the year (see section 22(c) and sections 29.22(c)-1 to 29.22(c)-8, inclusive)."

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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 830

PHILIP F. BOYNTON, PETITIONER

v.

REA FORHAN PEDRICK, as Administratrix of the Estate of William J. Pedrick, Deceased, Late Federal Collector of Internal Revenue in and for the Second New York Division

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 196-201) is reported at 136 F. Supp. 888. The opinion of the Court of Appeals (R. 203-206) is reported at 228 F. 2d 745.

JURISDICTION

The judgment of the Court of Appeals was entered on December 7, 1955. (R. 207-208.) A pe-

tition for rehearing was filed by the taxpayer (R. 209-217) and was denied by order entered January 11, 1956 (R. 220-221). The petition for a writ of certiorari was filed on April 6, 1956. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTIONS PRESENTED

1. Does the taxation of income computed on the accrual basis violate any provision of the Constitution of the United States?

2. Does a taxpayer who keeps his books on the accrual basis have the right, under Section 41 of the Internal Revenue Code of 1939, to report his income on the cash basis?

3. Is it unlawful for the Commissioner to require that taxpayer use inventories in computing the income from his business for income tax purposes?

4. Has taxpayer been deprived of any right to trial by jury?

CONSTITUTIONAL PROVISION, STATUTE AND REGULATIONS INVOLVED

Constitution of the United States, Sixteenth Amendment:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Internal Revenue Code of 1939:

> SEC. 22. GROSS INCOME.
>
> * * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

(26 U.S.C. 1952 ed., Sec. 41.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.22(c)-1. *Need of Inventories.*—In order to reflect the net income correctly, in-

ventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. * * *

Sec. 29.41-2. *Bases of Computation and Changes in Accounting Methods.*— * * * in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. * * *

* * * * *

STATEMENT

The material facts, as revealed by the opinions of the District Court (R. 196-201) and the Court of Appeals (R. 203-206), may be summarized as follows:

Taxpayer is in the business of buying, processing and selling sheepskins. Over ninety percent of his business is done on credit. Throughout the tax years in question he maintained his books on an accrual basis. Inventories were taken and used by taxpayer's accountant in preparing a yearly profit and loss statement, but were not entered in the regular books of account. (R. 196.)

The profit and loss statements based on the inventories were prepared using the accrual method in order to obtain credit from banks and suppliers of raw materials. (R. 200.) Taxpayer's accountant testified he told taxpayer the inventories were necessary in preparing the tax returns in question,

but that taxpayer refused to have the inventories used in making up the returns. (R. 205-206.)

Taxpayer prepared his returns for 1943 and 1944 on the cash basis. The Commissioner recomputed his income on an accrual basis and assessed deficiencies accordingly. Taxpayer paid the deficiencies and sued for refund in the District Court, where he contended that he had the right to file his returns on the cash basis. In the District Court proceedings the parties agreed upon the amount of income and tax due under the respective methods of computation, that is, accrual basis and cash basis. (R. 197.)

The District Court granted the Government's motion for a directed verdict on the issue of the correctness of the assessed deficiencies and incident interest, on the grounds set forth in its opinion. (R. 196-201.) The issue of the correctness of assessed penalties was submitted to the jury in the form of questions as to taxpayer's negligence or intentional disregard of rules and regulations in reporting his income. The jury found that taxpayer's failure to report his income properly was due to negligence. (R. 204-205.)

The Court of Appeals affirmed the judgment of the District Court in a *per curiam* opinion. (R. 203-206.)

ARGUMENT

1. Under attack here is the Commissioner's determination, sustained by the lower courts, that for federal income tax purposes the taxpayer must compute the income from his business on the ac-

crual basis. In seeking review by this Court taxpayer first contends (Pet. 8-9) that it is unconstitutional to require him to report his income on the accrual basis. More particularly, he argues that the power to tax income without apportionment, granted to Congress by the Sixteenth Amendment, *supra*, p. 2, extends only to income actually received; and hence that income accrued but not received may not be taxed without apportionment, regardless of the taxpayer's accounting basis. This argument—characterized, with taxpayer's other constitutional points, as "troglodytic" by the court below (R. 205)—is clearly without merit.

For many years this Court has recognized as valid for tax purposes the computation of income on the accrual basis. And it has repeatedly required taxpayers on the accrual basis to report income when accrued, regardless of when received. *Spring City Co.* v. *Commissioner*, 292 U.S. 182, rehearing denied, 292 U.S. 613; *Continental Tie & L. Co.* v. *United States*, 286 U.S. 290; *United States* v. *American Can Co.*, 280 U.S. 412. In the *Spring City Co.* case this Court said (pp. 184-185):

> Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues.

The principle thus stated is still controlling law today. Accrual basis taxpayers must report income

when their right to it becomes fixed. The taxpayer's attempt to find in this familiar and elementary principle a violation of the Constitution —an attempt obviously resting on the mistaken notion that the Sixteenth Amendment is the source of federal power to tax incomes [1]—is plainly unsubstantial.

2. Taxpayer further contends (Pet. 3, 8) that accrual basis taxpayers are entitled to report their income on the cash basis, under Section 41 of the Internal Revenue Code of 1939, *supra*, p. 3, because (Pet. 8) "in a full accrual set of books there is always contained a complete account of cash receipts and disbursements which clearly reflects income on the cash basis."

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[1] The Sixteenth Amendment merely removed the requirement of apportionment where the tax on income had previously been regarded as a tax on the source and therefore a direct tax requiring apportionment. *Brushaber* v. *Union Pac. R.R.*, 240 U. S. 1, 12-14, 17-19; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 112-13. However, a tax on profits derived from carrying on a business was never considered a direct tax, and Congress was fully empowered to impose such a tax even before the Sixteenth Amendment was adopted. See *Spreckels Sugar Refining Co.* v. *McClain*, 192 U. S. 397; *Flint* v. *Stone Tracy Co.*, 220 U.S. 107. Consequently, even if the taxpayer were correct in assuming that an accrued right to receive income from his business is not "income" within the meaning of the Sixteenth Amendment, Congress would not be precluded from levying a tax on such a right, since it would not be a direct tax requiring apportionment.

In any event, the taxpayer is wrong in assuming that income under the Amendment can only mean cash in hand. Values received, whether in the form of tangible property or intangible rights (here, the obligation of taxpayer's customers to pay for the goods sold to them), have always been considered as representing income. See *Crane* v. *Commissioner*, 331 U.S. 1, 15.

This argument is patently unsound. The fact that an account of cash receipts and disbursements is complete does not necessarily mean that it provides a clear reflection of income. On taxpayer's view, the very statute upon which he relies would be meaningless; for Section 41 provides in pertinent part:

> The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

If the cash basis of accounting invariably provided a clear reflection of income, simply because the taxpayer's books contained complete data as to cash receipts and disbursements, there would be no room for the exercise of the power expressly given to the Commissioner by Section 41. But the power thus given has considerable substance. As this Court said in *Lucas* v. *American Code Co.*, 280 U.S. 445, 449—

> the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income. Much latitude for discretion is thus given to the administrative board charged with the duty

> of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful.

It necessarily follows that it is open to the Commissioner to determine in a given case that the cash basis does *not* provide a clear reflection of income and, even though taxpayer has regularly kept his books on that basis, to require computation of income for tax purposes on the accrual basis. Conversely, where a taxpayer has kept his books regularly on the accrual basis, he may not depart from that basis in reporting his income without the Commissioner's permission. *United States* v. *American Can Co.*, 280 U.S. 412, 420. In any case, the Commissioner's determination of the proper accounting method may be challenged only upon a clear showing that he has abused his discretion. *Standard Paving Co.* v. *Commissioner*, 190 F. 2d 330 (C.A. 10th), certiorari denied, 342 U.S. 860.

3. Taxpayer further contends (Pet. 2-3, 9-12) that it is unlawful for the Commissioner to require, in this case, that taxpayer use inventories in computing his income. In weighing this contention it is necessary to bear in mind the relevant provisions of the Code and of the Treasury Regulations.

Section 22(c) of the 1939 Code, *supra*, p. 3, provides that—

> Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such tax-

> payer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

This statutory delegation of authority confers a broad discretion on the Commissioner. As this Court said in *Lucas* v. *Structural Steel Co.*, 281 U.S. 264, 268: "Whether in a particular business inventories are necessary for the determination of income is a practical question left by the statute to the judgment of the Commissioner." And the Court concluded in that case (p. 271): "The Company's case falls far short of meeting the heavy burden of proving that the Commissioner's action was plainly arbitrary."

In exercise of his authority the Commissioner, with the approval of the Secretary of the Treasury, has promulgated two relevant provisions in the Treasury Regulations. The first, Section 29.22 (c)-1 of Treasury Regulations 111, *supra*, pp. 3-4, provides that—

> In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

The second, Section 29.41-2 of Treasury Regulations 111, *supra*, p. 4, provides that—

> in any case in which it is necessary to use an inventory, no method of accounting in regard to

purchases and sales will correctly reflect income except an accrual method.

In sum, where the production, purchase, or sale of merchandise is an income-producing factor, the taxpayer must use the accrual method of computing his income, utilizing inventories in such computation. This plainly appropriate requirement has been sustained and applied in recent decisions by two Courts of Appeals. *Caldwell* v. *Commissioner*, 202 F. 2d 112 (C.A. 2d); *Herberger* v. *Commissioner*, 195 F. 2d 293 (C.A. 9th), certiorari denied, 344 U.S. 820.

4. Taxayer's final contention (Pet. 3, 13) is that he has been deprived of the right to trial by jury (Pet. 3) "recognized in section 3772 (d) of the Internal Revenue Code (1939) and the Seventh Amendment * * *."[2] More specifically, taxpayer contends (Pet. 13) that he was deprived of his right to trial by jury on the questions, "among others," (1) whether his accounting method "more clearly resembles cash than accrual;" (2) whether his accounting method "clearly reflected his taxable income under the XVI Amendment;" and (3) what his taxable income was for the years 1943 and 1944, "determined on the facts under applicable principles of law."

Under Treasury Regulations sustained and applied by the Second Circuit in *Caldwell* v. *Commis-*

[2] The statutory provision relied upon, Section 3772 (d) of the 1939 Code, is totally irrelevant. It provides that a suit against a Collector for refund shall be treated as if the United States had been a party, in applying the doctrine of *res judicata*.

sioner, supra, and the Ninth Circuit in *Herberger* v. *Commissioner, supra,* a taxpayer must, as a matter of law, use the accrual method of computing his business income, utilizing inventories in such computation, where the production, purchase, or sale of merchandise is an income-producing factor. That being true, and it being undisputed in this case that taxpayer's business involved the production, purchase, or sale of merchandise, it is immaterial what basis taxpayer used in keeping his books—although in fact it appears that he kept his books on the accrual basis. Nor was there a question of fact for the jury as to the amounts of taxpayer's taxable income for the years involved, since the parties were agreed upon the amounts both of income and of tax due under the respective methods of computation. (R. 197.)

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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CHARLES K. RICE,
Assistant Attorney General.
HILBERT P. ZARKY,
GRANT W. WIPRUD,
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MAY, 1956

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

PHILIP F. BOYNTON, PETITIONER,

v.

REA FORHAN PEDRICK, as Administrator of the Estate of William J. Pedrick, deceased, late Federal Collector of Internal Revenue in and for the Second New York Division, RESPONDENT.

PETITION FOR REHEARING OF PETITIONER'S PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

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To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Your petitioner, Philip F. Boynton, prays a rehearing of his petition to this Court for a writ of certiorari to the United States Court of Appeals for the Second Circuit filed in the office of the Clerk of this Court on the 6th day of April, 1956, and denied by this Court on May 21, 1956.

The grounds for this petition are intervening inaccuracies and half-truths contained in the Government's brief in opposition to the petition which could mislead this Court, significant omissions therefrom and

substantial grounds available to the petitioner and not previously presented, to wit: despotism of Government Departments.

The petitioner particularly calls the attention of this Court to the growing despotism of the Executive Department and of the inferior branches of the Judiciary Department of this Government which are infringing upon and overriding his constitutional rights in a manner reminiscent of a police state.

The Bureau of Internal Revenue, is guilty of despotism as to this petitioner (and as to the millions of other taxpayers) in denying to him

(a) the right to report his income and pay his tax, calculated on the cash basis, as secured to him by the Sixteenth Amendment of the Constitution and Section 41 of the Internal Revenue Code (1939);

(b) the protection of Article I § 9 of the Constitution by assessing deficiency taxes against him upon a so-called accrual basis but without apportionment among the States;

(c) the same application of section 22(c) of the Internal Revenue Code (1939) accorded to farmers with inventories who, under Reg. 111; § 29.22(a)-7, are permitted to report income on the cash basis without using inventories to determine income, thus denying this petitioner the equal protection of the law.

These fundamental, decisive constitutional rights were squarely presented to the District Court for the Southern District of New York and the Court of Appeals for the Second Circuit, as the foundation of this suit but both Courts have failed even to discuss them.

It is impossible to glean from their opinions reported at 136 F. Supp. 888 and 228 F. (2d) 745,

respectively (R. 196, 204), any discussion of, or even a direct reference to, these asserted rights. No one throughout the whole United States, where these law reports circulate and are read, could be apprised from reading either of both those opinions that demand for relief from the invasion of these constitutional rights was the essence of this suit.

If the lower courts had deliberately intended to smother these constitutional demands presented to them in this suit they could not have achieved a more successful result.

This American citizen and taxpayer came to the federal courts for the protection of his property from illegal seizure by the Executive branch. The federal courts have arbitrarily refused to determine upon their merits the demands for relief from these violations of his constitutional rights he—as a citizen and taxpayer—has presented for adjudication; but, instead, the Court of Appeals termed them "troglodytic", without further description or discussion, and threw him out of court. That, we insist, is an act of despotism which cannot be condoned by this Court.

It is a well known political maneuver, when an opponent cannot be answered, to attempt to hold him up to ridicule. That hoary expedient has no proper place in the federal courts of this country.

The petitioner now looks to this Court of last resort to protect him against this despotic infringement of his right of property and his right to his day in court inflicted by these two branches of the federal government.

To be sure, from the limited view-point of a government edging down the road to Fabian socialism, this case would undoubtedly present what might be called a "hot potato." And a return to constitutional enforcement of the Revenue Laws as limited by the Six-

teenth Amendment might require some adjustment to the extent of doing away with those illegalities for which the Bureau is responsible, but that is no reason why the law should not be enforced or why the rights of this citizen should not receive full protection at the hands of this Court.

From a purely economic standpoint, the taxation of unsold inventories and the denial of deductions from gross income of cash expended in purchasing them in the year of purchase, as illustrated in this case, is a short-sighted restriction on business expansion, which a little calm, informed reflection on the part of the Bureau should clearly demonstrate. Business expansion results in more income and, hence, more taxes.

The respondent's brief in opposition to the petition for a writ was inaccurate when it stated at page 2 as "Questions Presented"

> "2. Does a taxpayer who keeps his books on the accrual basis have the right, under Section 41 of the Internal Revenue Code of 1939, to report his income on the cash basis?"

This taxpayer did *not* keep his books on the accrual basis because inventories were not included in his books (R. 87, 90, 100). They are *necessarily* included in accrual books (R. 91, 109). They are *not* necessary in books kept on the cash basis (R. 91-2).

At best, a question of fact on this point, as well as the question, what is *in fact* the clearly reflected income of this taxpayer, were for the jury (R. 53) but were erroneously taken from it in violation of this petitioner's right of trial by jury.

The petitioner does *not* assume that income under the Amendment can only mean cash in hand, as the Government brief suggests in the last paragraph of

the note on page 7. There can be no question that, any tangible property actually or *constructively received* during the taxable year falls within the definition of income contained in the Amendment. Intangibles, such as accounts receivable, have no place in cash accounting as such; but a cash basis taxpayer has the right to keep a record of accounts owing.

Again, in its brief, the Government *did not dispute* that a *conflict* exists between circuits as to the application of § 41 I.R.C. (1939) as pointed out at pages 11 and 12 of petitioner's petition for a writ.

This omission is highly significant since the *Glenn* and *Osterloh* cases hold that books kept honestly reflect the income under § 41 I.R.C. (1939). These books were honestly kept.

The plea for broad powers under § 41 appearing on page 8 of the Government's brief indicates that Congress had not been informed—by the Treasury Department—of all applicable accounting facts and procedures. If the statute, as enacted, now proves to exclude support for an unconstitutional alternative application of accrual accounting by the Bureau, nevertheless the section must be enforced to the extent that it is valid with respect to cash accounting.

Furthermore, the Government's brief does not discuss *nor dispute* that this taxpayer (and millions of others with inventories) is grossly discriminated against in the application of § 22(c) I.R.C. (1939) as compared with farmers on the cash basis.

This rank discrimination as compared with farmers and the illegal segregation of others than farmers into an underprivileged class is totally ignored by the Government in its brief—a tactic in common with the lower courts in this case.

The petitioner looks to this Court boldly to drag this un-American condition out into the light of day

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hat it be granted.

HORACE M. GRAY,
Counsel for Petitioner.

I hereby certify that this petition is made in good faith, upon intervening circumstances of substantial effect and upon other substantial grounds available to the petitioner, although not previously presented, to which this petition is restricted, and not for purposes of delay.

HORACE M. GRAY.

June 7, 1956.